Building Immunity to Contagion

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For most of the past decade, yield-hungry investors bought emerging markets bonds and, at the slightest whiff of trouble, would sell the entire asset class, as if there were no differences among the bonds of different countries. All emerging countries were saddled with the curse of contagion, and struggled to free themselves from it.

Now some emerging countries have taken steps to rearrange their financial affairs and make themselves resistant to contagion. Investors are taking note and becoming more discriminating. In the months surrounding the Argentine crisis, international portfolio investors did not act like lemmings. They dumped their holdings of Brazilian securities, but most of them held onto their Mexican and Chilean securities. The market prices of Mexican and Chilean bonds wavered but did not crumble, and the national currencies of those two countries held their ground quite well. From mid-2001 to mid-2002 the Mexican peso fluctuated in the range of 8.99 to 9.99 per dollar, and during the worst days of the crisis held steady in the range of 9.1 to 9.2 pesos per dollar. This shows that international portfolio investors now consider Mexico completely de-coupled from Argentina. They perceive the dissimilarity between the two countries' financial sectors.

Also encouraging is that, despite its geographical proximity, Chile survived Argentina's crisis almost completely unscathed. The Chilean peso held its value versus the US dollar as the crisis raged, fluctuating only 4% in the first half of 2002. Indeed, there were reports that Argentines were buying Chilean pesos as a refuge and as a store of value. This impressive stability compares favorably with the shakier performance of the Chilean peso following the outbreak of the 1997 Asian crisis. In the aftermath of that earlier crisis, the peso weakened 10.5% versus the US dollar from July 1997 to June 1998.

Evidently Mexico and Chile differentiated themselves from Argentina in the minds of international portfolio investors, and Brazil did not. The consequence was that when investors dumped their Brazilian bonds and held

onto their Mexican and Chilean bonds, they inadvertently helped transmit the Argentine crisis to Brazil. The country risk of Brazilian bonds shot up by as much as 600 basis points in the March 2001 to June 2002 time frame.

There are many explanations for this striking difference in investors' willingness to hold these three countries' bonds. Mexico and Chile do not have any intrinsic God-given advantage over Brazil. The financial sectors and policies of the three countries display differences and similarities. Each country has rapidly diversified its exports but still depends on cyclical export commodities. Each is capable of high growth and has achieved high growth for periods of time in the recent past.

Certainly, however, in the bondholders' minds, there was a perceived difference. As the crisis unfolded, bondholders must have tried to quell the doubts that pricked them as they lay sleepless in bed at night. Evidently, in the case of Brazil, many of them decided that they could not tolerate the risks. There must have been too many uncertainties eroding their confidence that they would be paid, so they sold.

This fact justifies structuring Brazil's sovereign debt differently. The ideal plan would involve refinancing the debt with new instruments that have features like collective action clauses and outside guarantees. The new instruments would alleviate foreign portfolio investors' worries about local events in Brazil. Modern financial innovations now make it possible for emerging countries to design and issue bonds that foreigners will hang onto regardless of rumors and news. Foreigners know they cannot stay abreast of events in the countries where they invest, so guarantees bolster their confidence. Local investors may be better informed but have too much exposure, so they too value guarantees highly. There is a role for large insurance companies. They have underwritten municipal bond offerings in the U.S. for many years; now they are underwriting bond offerings in the emerging countries. These guarantees cost money, but cost less than financial crises.

Many Latin American countries can profitably reexamine their debt management policies and make improvements in the ways they obtain financing. Many of them can benefit from issuing newly-designed bonds and using the proceeds to repay existing debt obligations. After an emerging country has refinanced its debt, it will have will have acquired some immunity to contagion, and will have lowered its cost of borrowing. It will

then be able to borrow more without triggering a financial crisis and without exposing other emerging countries to risk of contagion.